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ASIAN FIXED INCOME OUTLOOK

June 2018

Summary

- In May, US Treasury (UST) yields ended lower. A solid US jobs report supported the bearish bias in UST yields that prevailed. However, the continued rise in oil prices drove 10-year yields to above 3% before retreating, following the release of seemingly dovish FOMC minutes. Towards month-end, USTs gained traction as political turmoil in Italy intensified.

- Overall, 10-year yields ended at 2.86%, about 10 basis points (bps) lower compared to end-April.

- As for Asian credits, overall performance came in flat in May, with high-grade outperforming high-yield. For high-grade, a decline in USTs cushioned the widening in credit spreads. Asian high-yield corporate spreads widened as weak sentiment over Emerging Market (EM) assets persisted.

- In economic news, the Philippine economy posted the fastest first quarter GDP growth in the region. Elsewhere, uncertainty in Sino-US trade relations continued to linger, while the monetary authorities in Indonesia and the Philippines raised their respective policy rates. Market news was also focused on Malaysia's general election, of which the opposition coalition won a convincing victory.

- The People's Bank of China (PBoC) announced several measures to further facilitate cross-border yuan fund flows, so as to bolster liquidity in the offshore yuan market.

- Meanwhile, activity in the primary market remained relatively robust in May. There were 23 new issues worth around USD 12.7bn in the high-grade space, while 23 new issues worth around USD 5.0bn in the high-yield space.

- We are positive on Indonesian and Chinese bonds. The reduced risk of further rupiah depreciation stemming from Bank Indonesia (BI) 's tightening actions, as well as the recent softening in oil prices, are some reasons that support Indonesian bonds. We maintain that China's focus on growth over deleveraging suggests that more targeted easing could be forthcoming. In contrast, we are underweight India and Philippine bonds as we hold the view that the respective central banks may hike their policy rates soon.

- On the currency front, we prefer the Renminbi (RMB), Thai Baht (THB) and Malaysian Ringgit (MYR) over the Indian Rupee (INR) and Philippine Peso (PHP).

- For Asian credits, the issuance of high-grade has declined in recent weeks but spreads continue to be pressured by a variety of risk factors, such as volatile UST markets and the weak performance of EM assets. However, fundamentals have remained largely intact, putting a cap on the level of spread widening. Asian high-yield remains pressured by worries over the new issuance pipeline, especially from China.

Asian Rates and FX

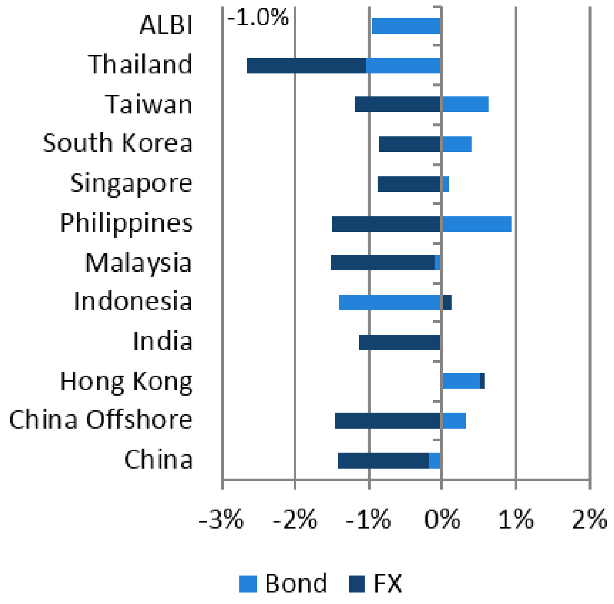
Market Review

UST yields ended lower in May

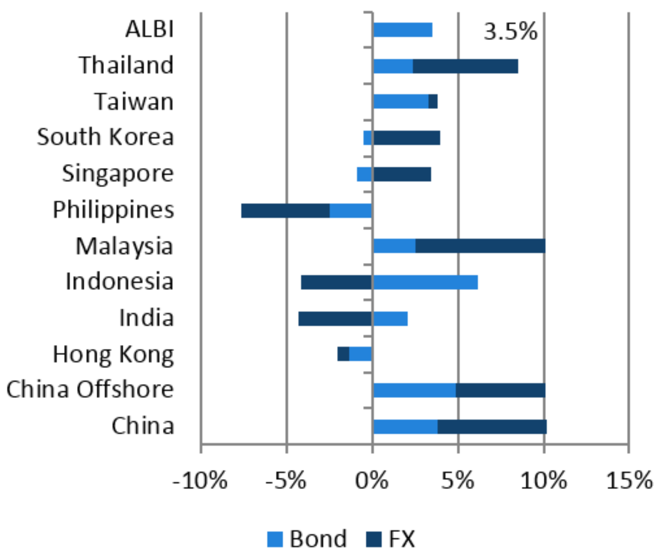
A US jobs report that confirmed hiring remained solid in April supported the bearish bias in UST yields that prevailed last month. However, it was the continued rise in oil prices, prompted in part by the US' decision to finally withdraw from the Iran nuclear deal, which drove 10-year yields to an intra-month high of 3.1261%. Yields retreated not long after, with the 10-year point falling below 3%, following the release of seemingly dovish FOMC minutes. Markets read the language to mean that the Federal Reserve (Fed) was willing to tolerate a short-term overshoot of its inflation target. Towards end of the month, gains in USTs found traction as the political turmoil in Italy intensified, rekindling concerns of a Eurozone exit. Overall, 10-year yields, ended at 2.86%, about 10bps lower compared to end-April.

Markit iBoxx Asian Local Bond Index (ALBI)

For the month ending 31 May 2018



For the year ending 31 May 2018



Source: Markit iBoxx Asian Local Currency Bond Indices, Bloomberg, 31 May 2018

Note: Bond returns refer to ALBI indices quoted in local currencies while FX refers to local currency movement against USD. Returns are based on historical prices. Past performance is not necessarily indicative of future performance.

Philippines posted the fastest first quarter GDP growth in the region

The Philippine economy grew fastest among major Asian economies in the first quarter of 2018. The acceleration in GDP growth was broad-based, boosted by rapid increases in fixed investment and government consumption. Thailand's economy rose at the fastest pace in five years in the first quarter, boosted mainly by strong exports and tourism. Meanwhile, economic expansion in Indonesia moderated in the same period, dragged by weak household and government spending. Similarly, there was a deceleration of economic activity in Malaysia in the first quarter of 2018, as government consumption growth fell sharply.

PBoC announced steps to bolster liquidity in the offshore yuan market

The Chinese central bank announced several measures to further facilitate cross-border yuan fund flows. Among other things, overseas yuan clearing banks and participating banks are now allowed to tap liquidity from the onshore market by raising funds through interbank borrowing, cross-border account financing and interbank bond purchases. In addition, the PBoC also pledged to implement bilateral local currency swap agreements, and enhance overseas investors' ability to use foreign currencies or the yuan for investment under the stock connect schemes.

Uncertainty lingers in Sino-US trade relations

Mid-month, US-China trade tensions were ratcheted down somewhat after both countries released a joint statement declaring a truce in their trade row. US Treasury Secretary Steven Mnuchin and Chinese Vice Premier Liu He separately said that both countries have agreed to suspend tariffs on each other, while negotiations to "substantially reduce" the US' merchandise trade deficit with China continue. However, about a week later, US President Trump declared that he was moving ahead with plans to impose tariffs on USD 50mn of Chinese imports, and curb investment in sensitive technology.

Market Outlook

Prefer Indonesia and China bonds, underweight India and Philippine bonds

The ongoing political crisis in several European countries (particularly Italy and Spain) will continue to weigh on risk sentiment and support safe-haven purchases. However, we see this being offset by higher inflationary expectations as positive momentum in the US economy persists. Nonetheless, we believe that in the near-term, economic news may take a back seat to ongoing developments in Italy, and the progress (regression) in trade relations between the US and China. Markets have largely priced-in a June rate hike by the US Fed, and we see greater attention to the upcoming ECB meeting, as investors endeavor to understand the central bank's position on QE tapering. Once stability in Italian/Spanish politics is perceived, market focus will likely revert to the Fed outlook.

Within Asian local government bonds, we prefer Indonesia and China over Philippines and India. With BI's shift to tightening, the risk of further sharp depreciation in the rupiah has been reduced. This, together with the recent softening in oil prices, should provide some relief to Indonesian government bonds. Moreover, passive flows into the space (as Indonesia is added to the Bloomberg Barclays Global Aggregate Index in June) should boost returns. Meanwhile, we maintain that Chinese policymakers' recent rhetoric focusing on growth over deleveraging suggests that more targeted easing could be forthcoming. This, together with expected moderation in growth, should be supportive of demand for bonds. In contrast, we hold the view that the Philippine central bank could be behind the curve in curbing inflationary pressures, and may have to hike its policy rate again as early as June. Hence, our underweight call on Philippine bonds. Separately, there is increasing possibility that the Reserve Bank of India may raise rates soon, on the back of robust growth and rising inflationary pressures.

Prefer RMB, THB and MYR over INR and PHP

Thailand's income terms of trade continues to benefit from rising tourism income, supporting our positive view on the THB. Similarly, Malaysia's current account position has significantly improved since the second half of 2017, and economic activity remains robust. We believe that weakening in the ringgit following the historic election surprise would be temporary. The appointment of a credible cabinet, coupled with positive fundamentals, provide reassurance. Meanwhile, Chinese policymakers have declared that further opening up of the financial sector may be realised as early as end-June. Continued reforms are likely to be supportive of the RMB. Moreover, increased demand for the currency is anticipated as Chinese shares are added to the MSCI equity benchmarks on 1 June. Meanwhile, India's and the Philippines' weak current account position is likely to prompt underperformance in the rupee and peso. Negative real rates in the Philippines will further weigh on demand for the latter.

Asian Credits

Market Review

Asian credits ended flat in May

Overall Asian credits ended flat in May. For high-grade, a decline in UST yields cushioned the widening in credit spreads. Consequently, Asian high-grade returned +0.37%, outperforming high-yield which returned -1.23%. Asian high-yield corporate spreads widened by 42bps. Weak sentiment over EM assets persisted, and although there was some stabilisation in EM towards the end of the period, overall spreads still closed the month 16bps wider.

Indonesian and Philippine central banks hike rates

Monetary authorities in Indonesia and the Philippines raised their respective policy rates in May. After holding both a scheduled and unscheduled meeting in May, BI raised its policy rate by a total of 50bps in the month. The move was largely a policy response to stabilise the rupiah, which weakened significantly as a result of outflows from emerging markets. Meanwhile, the Bangko Sentral ng Pilipinas (BSP) raised rates to curb rising inflationary pressures. Towards the end of the month, the Philippine central bank announced that it will cut the reserve requirement ratio by 100bps, effective 1 June, describing the move as part of "operational adjustments," as the central bank "shifts towards a more market-based implementation of monetary policy." The BSP explicitly stated that the move is "not intended to signal any change in the prevailing monetary policy stance."

Malaysia's opposition won a convincing victory at the general election

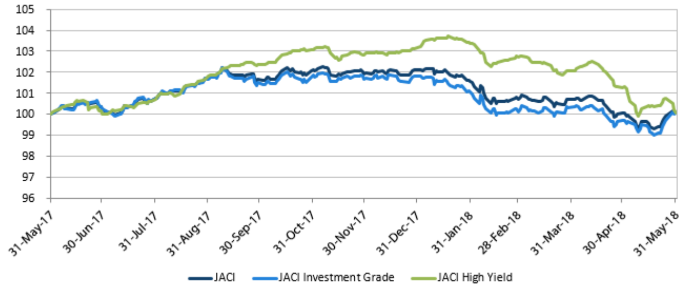
Malaysia's general elections threw up a surprise win for the opposition Pakatan Harapan (PH) coalition, which marked the first shift in power after six decades under the Barisan Nasional coalition. Dr. Mahathir Mohamad was subsequently sworn in as prime minister – a post which he held from 1981 until 2003. Post-elections, the Ministry of Finance, fulfilling PH's election pledge, announced that the goods and services tax will be effectively scrapped from 1 June, and that a sales and service tax may be introduced, to partly offset the revenue shortfall. Spreads of Malaysian credits widened meaningfully after the surprise election outcome, although there was a considerable retracement following the appointment of the cabinet and the formation of the Council of Eminent Persons (CEP).

Primary market activity remained busy

Primary market activity remained relatively robust in May, with total issuance amounting to about USD 17.7bn. There were 23 new issues worth around USD 12.7bn in the high-grade space, including a USD 2bn issuance from Perusahaan Listrik Negara, an Indonesian quasi-sovereign utility company, and USD 1.5bn issue from ICBCIL Finance Co Ltd. Meanwhile, the high-yield space saw 23 new issues worth around USD 5.0bn.

JP Morgan Asia Credit Index (JACI)

Index rebased to 100 at 31 May 2017



Note: Returns in USD. Past performance is not necessarily indicative of future performance. Source: JP Morgan, 31 May 2018

Market Outlook

High-grade new issuance registered declines but spreads remain under pressure

Within high-grade, the supply of new issuances have reduced in recent weeks. Previously, we had expected a large issuance from a number of issuers but this did not materialize as these issuers had issued Floating Rate Notes (FRNs) where demand has been strong. Nevertheless, spreads have remained under pressure from a variety of sources including volatile UST markets, weak performance of EM assets comprising both local currencies and bonds, and reduced local demand for USD Asian credit in recent months on the back of an expected robust pipeline. Until this dynamic alters, spreads are likely to remain under some pressure. However, fundamentals have remained largely intact, and this should cap the level of spread widening.

Supply worries in high-yield remains

Asian high-yield remains pressured by worries over the new issuance pipeline especially from China. Tightening onshore liquidity and the willingness of issuers to provide significant new issue concessions for new bonds, has caused secondary spreads to reprice wider. The recent default of China Energy Reserve and Chemicals Group International Co Ltd is also likely to weigh on sentiment towards the high-yield market.

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